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Lothar Mentel

Lead Investment Adviser to Cambridge

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What a mess, Morten Morland, 9 November 2020

End points and new beginnings

Just like 2020, 2021 has kicked off with rather more lively news flow than many will have hoped for when they gladly said goodbye on New Year's Eve to what many experienced as a truly *annus horribilis*. Yet even though events of massive importance have taken place since we last reported, they are, in most instances, end points of the old phase. Since the beginning of the Christmas break we have seen four years of Brexit disputes come to an end, the four years of Trump's tumultuous administration approaching its end (in very nearly the worst manner anybody could imagine), and the third national lockdown for the UK – but also with mass COVID-19 vaccinations of the elderly and vulnerable gaining speed and volume across the Western World.

The fact that capital markets continued trading in the upbeat mode they closed the last year with, tells us there are enough positive prospects on the horizon to make the negative news of the week fade in relevance. For the UK, there has been a sobering realisation that 'the deal' that replaces European Union membership terms for its main trade relationships is relatively thin and, in particular, does not cover services exports, which matters more for the UK economy than trade in goods, even if it is less tangible than empty shelves in supermarkets and price rises on cars. The muted response of currency markets is testimony that reaching this agreement was very much expected and priced-in, while the relatively more positive reaction of UK stock markets is only partially to do with the end of four years of trade uncertainty, and quite aligned with the global recovery rotation of business sectors that are highly geared to global economic activity levels, of which UK indices are full of in terms of energy, resource and bank stocks. We

are covering the opportunities and challenges that arise from the final closing of the Brexit chapter in a separate article this week.

The shocking hostilities in Washington D.C. over the passing of power from one US president to the next left the stock markets in New York City largely unaffected. Indeed, overall they rose on the day, because the events on Capitol Hill overwhelmed the more important piece of political news for markets, which was that against all odds and expectations, president-elect Biden's Democrats won both US Senate run-off elections in Georgia. This provides his incoming administration with the slimmest of majorities (a tied vote in the Senate means the Vice-President has the casting vote) and thereby turns the whole Congress (House of Representatives and Senate) in favour of the Democrats. Biden will have far greater legislative power to execute much of his structural renewal plans around infrastructure and green agenda. As we commented last year, this part of the Democrats' post-pandemic recovery stimulus programme had been seen by economists and markets as a more sustainable and lasting growth impetus than Trump's package of handouts and tax cuts. Given the slim majority, the jury is out on the increased probabilities of tax rises and anti-trust regulation bearing down on US tech giants. Judging by the initial market reaction, concerns over such headwinds remain very contained.

If both Brexit uncertainty and the Trump's volatile administration are nearing their natural end points, with positive prospects on the horizon, then the return of severe activity restriction in the wake of exponentially rising rates of COVID infections seem to paint a very different picture for the shorter term. And yet, despite the economic hardship these will inevitable – and often arbitrarily – bring for different parts of the economy, the medium-term outlook of markets is far more driven by the ramping up of the vaccination campaigns than the short-term pressures on the economy. Compared to the 2020 lockdowns, governments are once again making considerable efforts to prevent the worst for their respective economies, while the vaccines should lessen the need for the most stringent restriction over the coming months, and thereby support improvements in earnings expectations.

So, even though the start to 2021 currently feels very frustratingly similar to where 2020 ended, thanks to the arrival of numerous efficacious vaccines, the medium-term outlook this time round is characterised by much higher economic visibility than the mere hopes which held up sentiment last year. This is beginning to find its reflection in capital markets, where we have experienced a significant increase in the longest-term government bonds' yields. Market jargon refers to such rises as a bear steepening of the yield curve (between cash and long maturity bond yields). It is driven by improving growth expectations, and not just for the next couple of years, which undermines the value of bonds in circulation (hence bear, rather than bull steepening).

While this collective wisdom of capital markets bodes well for the 2021 economic development of corporate earnings growth in particular, rising long-dated bond yields can also quickly become a headwind for stock market valuation levels. As we explore in more detail in our December markets review article below, ultra-low bond yields in 2020 allowed historically exuberant valuation levels of equities to be broadly viewed as rational rather than irrational (i.e. in bubble territory). However, recovering bond yields put pressure on such valuation metrics and interpretations, because unless earnings begin to underpin valuations to the same extent as rising yields undermine their sustainability, then there is the risk that valuations drift toward irrationality. We will naturally monitor such developments closely, but for most of 2021 we firmly expect that earnings will indeed improve and – just as importantly – that when push comes to shove, central banks will keep a lid on bullish upward yield pressures through more quantitative easing

(QE). Why? Because, just as in March 2020, central banks understand more than anybody that unless financial markets remain stable, the economy lacks the breathing space to recover to its previous potential. Unfortunately, this brings with it the undesired side effect of asset bubbles forming in certain speculative areas. QE in the aftermath of the Global Financial Crisis led to such bubbles in commodities and some forms of property. This time, we already can see crypto currencies and certain tech market darlings such as Tesla distinctly in bubble territory. Ongoing 'bubble watch' will therefore be very much part and parcel of investment managers' ongoing duties during 2021 and, most likely, beyond.

December review: tidings of comfort and joy for investors

Asset Class	Index	December	Q4/2020	2020	2019	3-yr annualised	5-yr annualised	10-yr annualised
Equities	FTSE 100 (UK)	3.3	10.9	-11.5	17.3	-1.8	4.8	4.8
	FTSE4Good 50 (UK Ethical Index)	2.6	9.1	-14.5	13.9	-4.0	1.2	1.3
	MSCI Europe ex-UK	2.1	9.0	7.5	20.0	4.9	5.6	7.1
	S&P 500 (USA)	1.4	6.1	14.7	26.4	13.8	17.0	15.4
	NASDAQ (US Technology)	3.2	9.4	40.4	31.4	24.4	22.1	18.5
	Nikkei 225 (Japan)	1.7	9.0	11.0	15.0	3.0	5.4	9.1
	MSCI All Countries World	2.2	8.5	12.7	21.7	10.1	12.3	9.1
	MSCI Emerging Markets	4.8	13.2	14.7	13.8	6.2	12.8	3.6
Bonds	FTSE Gilts All Stocks	1.6	0.6	8.3	6.9	5.2	5.5	5.5
	£-Sterling Corporate Bond Index	1.7	4.0	8.6	11.0	5.6	6.7	6.9
	Barclays Global Aggregate Bond Index	-1.0	-2.3	5.8	2.7	4.5	6.4	4.2
Commodities	Goldman Sachs Commodity Index	3.5	8.3	-26.1	13.1	-8.2	-1.9	-8.8
	Brent Crude Oil Price	5.7	15.8	-23.9	17.9	-8.2	6.6	-5.9
	LBMA Spot Gold Price	4.2	-5.3	20.0	14.2	13.4	12.2	3.0
Inflation	UK Consumer Price Index (annual rate)*	-0.1	-0.2	0.3	1.3	-	-	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.5	0.9	0.7	0.6	0.6
Property	UK Commercial Property (IA Sector)*	-0.1	-0.3	-3.7	-0.8	-0.6	0.7	3.5

Data sourced from Morningstar Direct as at 31/12/20. * to end of previous month (30/11/20). All returns in GBP.

The end of 2020 may not have felt festive for most of us, but capital markets certainly had some cheer. At the global level, equities saw a 2.2% rise in December. It was a continuation of the disparity we saw throughout the year. As coronavirus numbers soared, and governments shut their nations down, the global economy sank to its deepest ever recession in 2020. Investors, meanwhile, were kept in surprisingly good spirits, as fiscal measures from governments combined with monetary countermeasures from central banks benefitted them disproportionately. December's performance capped off a strong quarter, half and year as a whole, with global equities up 8.5%, 12.1% and 12.7% respectively. With the pandemic piling a hammer-blow on economic activity, stock performances are clearly based on expectations of a strong 2021 – as we get further down the road to normality. But this means that – once again – markets are starting the year at extremely high valuation levels.

While markets as a whole fared well last month, the spoils were not shared evenly. Emerging markets proved the biggest winners into the year end, with stocks climbing 4.8%. The second-best regional

performer was the UK, edging up 3.3% over the month. That is not something we have been able to say often over the last few years. Just as with emerging markets, the UK's strong performance was clearly due to the cyclical nature of Britain's stock market – with many of the companies in the FTSE 100 benefit from rebounding global activity and improved economic expectations.

With activity sure to restart at some point this year, and Britain's vaccination programme well underway, UK stocks look well placed. When we add in the last-ditch signing of Boris Johnson's post-Brexit trade agreement, prospects look even better. While it will not come as much of a surprise for markets – as some form of light deal was the implied expectation – it will ease the uncertainty that has hampered businesses and smothered UK assets for the last five years. We devote a separate article to the deal below.

Unfortunately, a decent December and a stronger fourth quarter overall (UK equities ended Q4 up 10.9%) were still not enough to rescue Britain's year. UK equities finished the year 11.5% lower than where they were at the beginning of 2020. This makes the FTSE one of the few global market indices to register a negative year. European stocks climbed 7.5% in 2020, while Japan saw an 11% increase and both EMs and the US S&P 500 rose 14.7%.

But these performances pale in comparison to another US index, the Nasdaq Composite, which delivered a whopping 40.4% rise last year. This reflects the dominant year had by the US mega-cap technology stocks (with technology companies comprising over a fifth of the Nasdaq), which emerged as undisputed winners of the pandemic – and darlings of stock markets – as they were viewed as the only 'show in town' by many investors. Whether US tech can continue its astonishing outperformance this year is doubtful, however. Tech performance has already plateaued somewhat in recent months, with expectations of a cyclical rebound pushing investors into a sectoral rotation. And, with Joe Biden's Democratic Party now controlling both Houses of Congress, more stringent anti-trust laws brought to bear on the likes of Facebook, Amazon and Google, now appear more probable.

Looking to other asset classes, bonds had a mixed December. Once again, the UK outperformed, with UK government bonds and corporates both faring better than global bonds. Oil continued its rebound and, at $52 per barrel, the Brent Crude international benchmark finished the year at its highest point since the astonishing sell-off of February and March. Oil's strong fourth quarter was still not enough to turn 2020 positive, and prices finished the year 26.1% below where they were at the beginning.

Gold, on the other hand, fared extremely well, posting a 20% increase over the year. In the most strange and uncertain year in modern times, it seems investors were once again drawn in by what some regard as the ultimate safe-haven asset. No wonder it has been dubbed the 'currency of fear'. At the other end of the scale, UK commercial property struggled once more, capping a difficult year in which the physical retail industry – a huge factor in commercial property prices – had its longstanding difficulties compounded by the national shutdowns.

As written before, the positive year in capital markets would have been impossible if not for the continued extraordinary support provided by the world's central banks. Through their extensive asset purchase programmes, central bankers flooded the financial system with liquidity. First, to stop the financial frantic 'dash for cash' urge of market participants in the face of economic stress back in March, thereby pushing the 'risk-free' rate of government bonds down to non-existent levels, rendering risk assets the only alternative for positive returns.

On the one hand, this allowed governments to spend freely in plugging the gap between now and normality, an option which – with some hesitation – most have taken. On the other, it left investors with abundant capital, the promise of a rebound on the horizon and a much lower risk of widespread defaults due to extensive government support. The question stopped being "should I invest?" and became "where should I invest?" to the great benefit of risk assets.

If central banks holding the world together was one of 2020's main themes, the other was a noticeable shift in currency markets. Last year, we saw lasting weakness in the US dollar, paired with an enduring bout of strength from the Chinese renminbi. The dollar fell 6.7% on a trade-weighted basis last year, while the renminbi steadily climbed to its strongest level against the dollar since the first half of 2018. With the Chinese economy already growing past its pre-pandemic levels, and a global rebound coming next year, we should expect this trend to continue.

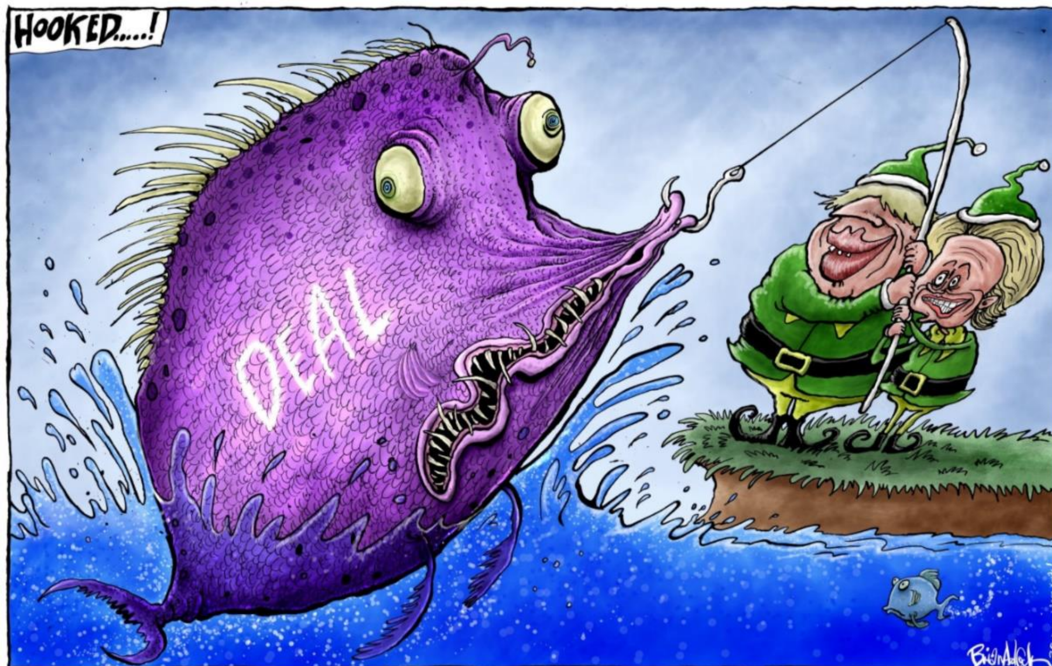
However, the otherwise very helpful and stabilising actions of central banks may have resulted in unwelcome side effects. As with previous episodes of extraordinary monetary support, the abundance of capital seems to have led to speculative rallies in certain asset classes and stocks which seem very hard to justify when applying historically proven valuation measures. In the aftermath of the 2008/2009 Global Financial Crisis, this was noticeable in the global commodity sector and, to a certain extent, property.

To be clear, at present, we are not talking about the general valuation levels of equities around the world. It is true that valuation multiples have risen to rival (in many instances exceed) levels that proved unsustainably high during the 1998-2000 dotcom boom. But, as laid out above, the extraordinarily low yields of bond investments (the only equivalently liquid alternative) makes those exuberant equity valuations 'rational' rather than 'irrational'.

What may be more bubble-like is the meteoric rise of certain technology companies like Tesla, and the renewed explosion of crypto-currency values. In both cases it is hard to identify long-term intrinsic value, an implied return which would justify both the expectations of holders of these assets and the inevitable risks which come from their lack of visibility. Both require belief rather than valuation, and that makes them vehicles for speculative trading rather than investment in the classic sense.

As we wrote in December's 2021 Outlook, this year much will hinge on the return of positive corporate earnings growth as the pandemic is brought under control versus sustained central bank support. If either one changes materially compared to current expectations, valuation adjustments have to be expected – both up and down.

Bye-bye 'Brexit', hello new 'Special Relationship'



Brian Adcock, 24 December 2020

In official civil service communications, the word 'Brexit' has been mostly absent for nearly a year. According to Downing Street diktat, Brexit is an historic event that occurred at the end of last January (or was it March 2019?). Therefore, we never need speak its name again. Negotiations on "changing regulatory alignment" and similar phrases were the official Whitehall-speak of recent months. It certainly has not felt that way for the public, of course. Despite the all-encompassing pandemic filling our newsfeeds and halting all else, Brexit has been one of the few stories that felt very much ongoing in 2020. But 2021 is a new year. The last-gasp agreement with the European Union has been ratified and announced by British and European lawmakers, finally locking-in the UK's regulatory break from the continent. At long last, 'Brexit' is consigned to history.

History will tell that it was mighty close. Boris Johnson's brinkmanship tactics brought us much nearer to a 'no-deal' exit than many would have liked. But even as self-imposed deadlines sailed by, capital markets (us included) seemed assured that common interest would prevail. Judging from movements in currency and equity values, investors never bought into the negative rhetoric coming from both sides of the channel. Indeed, as we wrote many times last year, the stakes were too high – and the barriers too low – for negotiations to end in misery. And after pesky fishing disputes were washed away, markets proved correct.

In terms of Britain's economy and asset markets, the fact that we have *a* deal rather than none is clearly a positive. But as analysts have repeatedly pointed out, anything less than full membership of the customs union – which Johnson's deal deliberately falls well short of – is likely to be less conducive to trade over the medium and long-term, thereby downgrading UK growth prospects.

For goods, the deal thankfully prevents any tariffs or quotas – which would have hurt consumers as well as Britain's exporters. But the lack of regulatory alignment means UK and EU businesses will face added bureaucratic costs when trading across the Channel, while international firms will find it much harder to distribute across the EU if they had chosen the UK as their access point to the common market. Altogether, this leads to the much-feared border disruptions in the short term and increased transactional costs for cross border trade.

However, disruption is even more likely on the services side, where Johnson's skinny deal looks skinniest. Despite accounting for 80% of the UK economy, and the bulk of export revenues, there is little provision in the deal for Britain's service providers, who will now lose their automatic access to EU markets, and will face increased restrictions in the short term.

The hope is that the skinny deal is only a starting point and will get plumper in time. But there are no guarantees, particularly for Britain's financial sector. The key sticking point is whether the EU will grant London's finance companies 'equivalence' – access to EU capital markets on the same basis as EU member states. Given the size and financial importance of the City of London on the global stage, the EU would certainly not want to cut off British financiers completely. But the European Commission is yet to make a decision on equivalence, awaiting clarifications from Johnson's government.

One key reason why the Commission *could* grant equivalence would be the amount of European share trading that goes on in London's financial halls (or rather, mainframe computer systems), blockage of which could cause liquidity shortages on the continent. But this might well not be a problem for Europe. Over the last four and a half years, European share trading has increasingly moved to centres in Paris and Frankfurt, in anticipation of post-Brexit difficulties. Without the danger of liquidity issues, EU negotiators have little incentive to hand out access to their markets.

We wrote in December's Outlook that these factors make it difficult to be overly positive about UK prospects. However, in large part, Brexit damage has already been done over the past five years, with many businesses making arrangements to move overseas or cut the UK out of their supply chains. And, since capital markets expected some form of skinny deal anyway, the upside that comes with it was already included in asset prices. As such, Britain reaching a trade deal with its largest trading partner contained no positive surprise for markets. And yet, following the announcement, UK assets fared well. Sterling gained 2% as the new year began, up to €1.12 against the Euro, and in the last few days the FTSE 100 has rallied to its highest since before the pandemic.

It would be hasty to attribute these moves wholly to Brexit positivity. Optimism in Sterling has come back down over the last few days, and it seems to have settled within the range it occupied for most of last year. FTSE positivity is certainly in full swing, but a large part of this is down to the sectoral makeup of Britain's stock market, which makes it particularly sensitive to a global cyclical rebound through its energy and materials exposure.

Putting the Brexit question to bed should help UK equities by simply clearing up lingering uncertainties. As we wrote in our UK outlook, Brexit has loomed so large over the UK for the last five years that its assets have been seriously unloved by international investors. This has left Britain's stock market with cheap valuations relative to its global peers – a fact that should help as global investors rebalance for the upcoming cyclical rebound. The fact that political uncertainties are fading provides a notable catalyst for this.

There is another benefit to the skinny deal. Regardless of what one thinks of Johnson's brinkmanship as a tactic, the constant threat of confrontation and a hard split created headaches for British and European businesses trying to plan ahead. But the latest deal was presented on both sides as a great achievement, and the start of a new, prosperous and friendly relationship between the UK and EU. Ill feeling has receded and, for now, the blame game has stopped. If this can continue, it bodes well for future negotiations on services, equivalence and all else. If it lasts, a calmer tone in negotiations could be the biggest thing to come out of this skinny deal.

CAMBRIDGE INVESTMENTS LIMITED

11th January 2021

Global Equity Markets

Market	Fri 16:08	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6860.8	+6.2	+400.2	↗	↗
FTSE 250	21077	+2.9	+588.3	↗	↗
FTSE AS	3875.3	+5.5	+201.6	↗	↗
FTSE Small	6362.8	+2.4	+147.3	↗	↗
CAC	5696.7	+2.6	+145.3	↗	↗
DAX	14059.7	+2.5	+340.9	↗	↗
Dow	31057	+1.5	+450.9	↗	↗
S&P 500	3815.6	+1.6	+59.5	↗	↗
Nasdaq	13170.6	+2.2	+282.3	↗	↗
Nikkei	28139.0	+2.5	+694.9	↗	↗
MSCI World	2734.2	+1.6	+44.1	↗	↗
MSCI EM	1322.3	+2.4	+31.0	↗	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
TUI	+30.8	easyJet	-5.3
Glencore	+18.4	British Land	-4.7
BP	+17.0	Carnival	-3.7
John Wood	+16.1	Rolls-Royce	-3.1
Anglo American	+15.9	Rightmove	-2.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.359	-0.6	Oil	55.47	+7.1
GBP/EUR	0.902	-0.9	Gold	1862.7	-1.9
USD/EUR	1.23	+0.3	Silver	25.88	-2.0
JPY/USD	103.81	-0.6	Copper	367.6	+4.4
CNY/USD	6.47	+0.8	Aluminium	2036.5	+1.9
Bitcoin/$	40,823	+39.6	Soft Cmdties	398.8	+1.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.29	+0.09
UK 15-Yr	0.51	+0.11
US 10-Yr	1.10	+0.19
French 10-Yr	-0.32	+0.02
German 10-Yr	-0.52	+0.05
Japanese 10-Yr	0.04	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.1	20.2	15.7	13.9
FTSE 250	1.8	19.9	20.0	15.1
FTSE AS	2.8	20.0	16.2	14.0
FTSE Small x Inv_Tsts	1.8	17.8	-	15.0
CAC	1.9	23.0	18.4	14.4
DAX	2.5	24.0	16.2	13.1
Dow	1.9	23.0	21.1	15.9
S&P 500	1.5	28.0	23.3	16.9
Nasdaq	0.7	38.4	30.5	19.2
Nikkei	1.4	29.2	25.0	17.3
MSCI World	1.8	26.3	21.7	16.0
MSCI EM	1.8	20.9	15.9	12.3

UK Mortgage Rates

Mortgage Rates	Dec	Nov
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.83	1.84
3-yr Fixed Rate	2.05	2.03
5-yr Fixed Rate	2.02	2.02
10-yr Fixed Rate	2.50	2.48
Standard Variable	3.62	3.62

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE